TABLE OF CONTENTS.

Citations to Opinions Below	1
Jurisdiction	2
Questions Presented	2
Statutes Involved	2
Statement of Facts	3
Reasons for Granting Certiorari	4
Conflict With Other Decisions	6
Fixed Maturity Date Not Essential to Indebtedness	6
Priority of General Creditors Is Not the Test	11
Investment of New Capital Is Not Essential to Indebtedness	12
Doctrine of Thin Capitalization Does Not Apply	13
Business Purpose Not Essential But Present	14
The Trial Court Erred in the Exclusion of Evidence	17
Conclusion	18
APPENDICES:	
A. Statutes Involved	19
B. Order of the United States Court of Appeals for the Sixth Circuit—Filed January 4, 1957	23

TABLE OF CONTENTS.

Cases.

Andersen Corp., 15 P. H. T. C. Memo., par. 46,116 ... 15

Bazley v. Com., 331 U. S. 737, 67 S. Ct. 1489 ... 14

Bowersock Mills & Power Co. v. Com., 172 F. 2d 904 (10 C. A. 1949) ... 13

1432 Broadway Corp. v. Com., 4 T. C. 1158 ... 14

Cleveland Adolph Mayer Realty Corp., 6 T. C. 730 ... 15

Com. v. J. N. Bray Co., 126 F. 2d 612 (5 C. C. A. 1942) ... 12

Com. v. Lafayette L. I. Co., 67 F. 2d 209 (7 C. C. A. 1933) ... 8, 11

Com. v. National Grange Mutual Liability Company, 80 F. 2d 316 (1 C. C. A. 1935) ... 8, 11, 12

Com. v. O. P. P. Holding Corp., 76 F. 2d 11 (2 C. C. A. 1935) ... 17

Com. v. Proctor Shop, 82 F. 2d 792 (10 C. C. A. 1936) 11

Conger's Estate, In re, 184 N. Y. S. 74 ... 10

Elliott-Lewis Company, Inc., 14 P-H Memo. T. C. par. 45,047 (1945) ... 11, 12

Harris v. Firth, 68 A. 1064 (N. J.) ... 11

Helvering v. Richmond F & P R Co., 90 F. 2d 971 (4 C. C. A. 1937) affirming 33 B. T. A. 895 (1936) ... 9, 17

Holtorf's Estate, In re, 28 N. W. 2d 155 ... 10

250 Hudson St. Corp., 15 P-H Memo T. C. par. 46,205 (1946) ... 13, 15

Idaho Lumber & Hardware Co., 14 P-H memo. T. C. par. 45,085 (1945) ... 11, 13

Keeler v. Hiles' Estate, 172 N. W. 363 ... 10

Kelley, John, Co. v. Com., 326 U. S. 521, 66 S. Ct. 299 (1946) 11, 12

Kraft Foods Co. v. Com., 232 F. 2d 118 (2 C. A. 1956) 13, 15

Lansing Hotel Corporation, 14 T. C. 183 (1950) 13

Mullin Building Corp. v. Com., 9 T. C. 350 (1947) 14

New England Lime Co. v. Com., 13 T. C. 799 (1949) 13, 14

Sabine Royalty Corp., 17 T. C. 1071 (1951) 13

Staked Plains Trust, Ltd., 12 P-H T. C. Memo, par. 43,381 (1943) affirmed 143 F. 2d 421 (5 C. C. A. 1944) 9

Third Scottish-American Trust Company, Ltd. v. U. S., 37 F. Supp. 279 (Ct. Cl. 1931) 8

Toledo Blade Co., 11 T. C. 1079 15

U. S. v. Title Guarantee & Trust Co., 133 F. 2d 990 (6 C/A 1943) 11, 17

Text.

7 *Merten's Federal Income Taxation* 3 5

Reports, Rulings, and Regulations.

Appeal and Review Recommendation No. 237, 3 Cum. Bull. 327;—1936 C. C. H. Federal Tax Service, Vol. 1, par. 822.522; 1939 C. C. H. Fed. Tax Service, Vol. 1, par. 822.263 ..... 7, 11

Regs. 103, § 19.504-2 (a) 7

Report of the Ways and Means Committee (74th Cong. 2d Sess. H. Rept. 2475) *Seidman's Legislative History of Federal Income Tax Laws*, 209 5

Statutes.

Internal Revenue Code, Act of Feb. 10, 1939, c. 2, 53 Stat. 1, as amended, Title 26 U. S. Code 2
Sec. 23 ..... 2, 17
Sec. 23(a) 7
Sec. 23(b) 19
Ohio General Code:
Sec. 8109 (R. C. 1301.06) 2, 10, 21
Sec. 8112 (R. C. 1301.09) 2, 10, 22
Revenue Act of 1918, Sec. 234(a)(2) 2
Revenue Act of 1936:
Sec. 14 ..... 2, 16, 19
Sec. 27 ..... 2, 21
Revenue Act of 1954, Sec. 163(a), 26 U. S. C. 163(a) 2
28 U. S. C. 1254(1) 2
28 U. S. C. 1340 2

In the Supreme Court of the United States

OCTOBER TERM, 1956.

No. ---------.

BEAVER PIPE TOOLS, INC.,

Petitioner,

vs.

THOMAS M. CAREY,

Respondent.

PETITION FOR WRIT OF CERTIORARI

To the United States Court of Appeals, For the Sixth Circuit.

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Sixth Circuit entered in the above entitled cases numbered 12,868 and 12,869 on the docket of such court on January 4, 1957, which affirmed judgments in two cases in the United States District Court for the Northern District of Ohio, Eastern Division, dismissing the complaints therein.

CITATIONS TO OPINIONS BELOW.

The memorandum opinion of the District Court in which the cases originated, filed December 29, 1955 (R. 69a-71a), is reported in 139 F. Supp. 470 and unofficially reported in 1956 P-H* Federal Taxes, Vol. 4, Par. 72,409. No opinion was rendered by the Court of Appeals. Its order filed January 4, 1957 is printed in Appendix B hereto (*infra*, p. 23) and is unofficially reported in 1957 P-H Federal Taxes, Vol. 4, Par. 72,446.

---

* Prentice-Hall.

JURISDICTION.

The judgment of the Court of Appeals was entered on January 4, 1957, *infra*, p. 23.

The jurisdiction of this Court is invoked under 28 U. S. C. § 1254(1).

The actions in the District Court arose under Internal Revenue Code, Act of February 10, 1939, c. 2, 53 Stat. 1 as amended Title 26 U. S. Code and original jurisdiction was conferred on such court by 28 U. S. C. § 1340.

QUESTIONS PRESENTED.

1. Were preferred debentures issued by Appellant in 1936 and 1937, in exchange for preferred shares theretofore issued by it and outstanding, evidences of indebtedness so that interest accrued and paid thereon in the years 1940-1949 was deductible under IRC § 23 in determining net income for Federal Income and Excess Profits Tax purposes?

2. Did the District Court err in the exclusion of evidence offered in behalf of plaintiff to show plaintiff's intention in issuing the preferred debentures?

STATUTES INVOLVED.

The statutory provisions involved are § 23 of the Internal Revenue Code Act of February 10, 1939, c. 2, 53 Stat. 1 as amended, 26 U. S. C. §23 which in substantially the same language has been in effect from Sec. 234 (a) (2) of the Revenue Act of 1918 and prior Acts down to the Revenue Act of 1954 § 163 (a), 26 U. S. C. § 163 (a). Incidentally involved are the Revenue Act of 1936, §§ 14 (a) (1) (A), (2), (b), (c); 27 (a), (d), (h) and the General Code of Ohio §§ 8109, 8112, (2).

All of such statutes are printed in Exhibit A.

STATEMENT OF FACTS.

The actions in the District Court were against the respondent, former Collector of Internal Revenue, for refunds of Federal Income and Excess Profits taxes paid by Petitioner for the calendar years 1940-1949, based upon the disallowance by the Commissioner of deductions for interest accrued and paid upon eight per cent preferred debentures in the principal amount of $192,000 issued in 1936 and 1937 by the petitioner in exchange for 1920 issued and outstanding shares of preferred stock of the par value of $100 each which preferred shares were restored to the status of authorized but unissued preferred shares in the corporation.

No issue of timeliness or form of any of the payments or proceedings is involved.

The rights of the holders of preferred debentures were superior to the rights of holders of $120,000 face amount of common debentures (Ex. E, R. 32a) authorized by the Board and issued December 31, 1936 as a dividend on common shares and to the rights of all shareholders (including any shareholders who should not exercise their option to make the exchange) but were subordinate to the rights of other creditors of Petitioner (R. 28a-29a, 33a).

Trial by jury was waived (R. 3a); both causes were consolidated for trial (R. 2a); they were tried primarily upon stipulations before The Honorable Paul Jones, District Judge, who found in favor of Defendant and dismissed the complaints (R. 3a, 4a, 71a).

The District Court held (R. 69a) that the debentures were not indebtedness of the corporation, primarily because they did not have a fixed maturity date but by their terms in absence of default did not mature until liquida-

tion of the company, and further noted that the preferred debenture holders were junior to general creditors (R. 70a) and his view that neither the fact that the Commissioner took no adverse action in respect of common debentures [which were junior to the preferred debentures and deduction of interest upon which was allowed] nor the fact that capital gains were recognized in the exchange of preferred debentures for ~~common debentures~~ preferred shares in taxing the individual shareholders furnished support for the claim that a debt was thereby created within the contemplation of the pertinent law and regulations (R. 71a).

The Court of Appeals affirmed (*infra*, p. 23) on the ground that the debentures had no fixed maturity date and for the further reason that the debentures were not issued for new capital and that they had a face value nearly ten times the stockholders' equity [per books] and were junior to the claims of general creditors.

REASONS FOR GRANTING CERTIORARI.

The Revenue Act of 1936 imposed a new surtax on undistributed profits of corporations at progressive rates ranging from seven to twenty-seven per cent, inclusive, against which credits were allowed, among others, for dividends paid during the taxable year including taxable dividends in obligations of the corporation taxable to the shareholders (*infra*, pp. 19-21).

During the tax year 1936 Petitioner, to avoid this surtax under the terms of the law, paid $57,600 cumulated and current dividends in cash upon its preferred shares; $8,000 in cash upon its common shares, and on December 31, 1936 $15 a share or an aggregate of $120,000 in common debentures issued as of December 31, 1936 (R. 21a, 27a-28a, 39a-41a). In order that the preferred sharehold-

ers might not be subordinate to the common debenture holders and further to obtain a deduction for interest paid by the Petitioner the preferred shareholders were offered the option at any time prior to March 1, 1937 to surrender the preferred shares held by them and receive in exchange preferred debentures (R. 26a-27a, 37a-39a).

The undistributed surtax law was an attempt to compel submission of all income earned through a corporate entity to two taxes in the year the income arose, one on the corporation and the second tax on the individual stockholder. Another purpose was to prevent withholding unneeded corporate income from shareholders. 7 *Merten's Federal Income Taxation* 3. We quote in part from the report of the Ways and Means Committee (74th Cong. 2d Sess. H. Rept. 2475) *Seidman's Legislative History of Federal Income Tax Laws*, 209—

> "* * * Individuals and partnerships cannot minimize their taxes by failure to distribute their business earnings. Corporations should not be permitted to withhold from the beneficial shareholders unneeded corporate income at the expense of the revenues of the United States and to the detriment of the shareholder. The bill proposes to remove many of these inequities by relieving from tax corporations which distribute all their net earnings annually as earned, and by taxing corporations accumulating their net income at a rate to compensate to a large extent for the amount of tax on the shareholders' income lost by reason of the failure to make a complete distribution. Adequate safeguards are provided in the bill to prevent unreasonable taxation of incomes in the case of corporations in distress or with inadequate earnings to take care of their immediate business needs."

Here the adequate safeguards provided in the act were availed of by Petitioner in the issue of Common Deben-

tures as a taxable dividend, and in the taxable exchange of Preferred Debentures for Preferred Shares so that interest thereon would be deductible. It thereby minimized the taxes on the corporation and avoided double taxation so far as legally permissible; but at the same time, the common shareholders were taxable on the dividend to them and the former preferred shareholders were taxable upon the gain resulting from the exchange, and thereafter both were taxable upon the interest paid upon the common and preferred debentures. They did not seek to evade tax on the common dividend and on the capital gain from receipt of Preferred Debentures respectively. Here is the very sort of thing sought to be brought about by the law.

Conflict With Other Decisions.

Petitioner's deduction of interest upon the common debentures which were junior and subordinate to the preferred debentures was allowed in all of the years (1937-1942) they were outstanding; and deduction of interest upon the preferred debentures was allowed for the years 1937-1939 (R. 45a-46a, 51a-53a). The deduction of interest upon the preferred debentures was in accordance, and the decisions of the courts below conflict in principal, with all of the rulings and decisions of the Bureau and of the courts prior to and at the time of the action taken by Petitioner and as well with many subsequent court decisions. We shall discuss these under the following captions.

Fixed Maturity Date Not Essential to Indebtedness.

The principal ground of decision in the courts below was that the debentures have no definite maturity prior to liquidation of the corporation except in event of default. The preferred and common debentures are substantially

identical except for name, interest rate, provisions for priority of principal and interest of the preferred debentures over the common debentures and the fact that the common debentures had a fixed maturity date. The Bureau recognized that the common debentures constituted indebtedness and allowed deductions of interest on them but denied that treament to the preferred debentures after 1939 for the sole reason that they do not contain a certain maturity date. That decision was in conflict with the rulings of the Bureau and holdings of the courts prior to the issue of the debentures. It is not an essential of indebtedness that a certain maturity be provided.

We find no case prior to the time of issue of the preferred debentures holding that a fixed or certain maturity date is essential to indebtedness. On the contrary, the rulings and decisions prior to 1937 as well as many subsequent decisions hold that a fixed maturity date is not essential.

Appeal and Review Recommendation No. 237, published by the Bureau of Internal Revenue in 1920 recognized that so-called debenture stock, the face amount of which was payable on dissolution or at the expiration of corporate existence of the issuer was indebtedness and that the interest thereon was deductible in determination of the taxable net income of the corporation. This ruling published in full in 3 Cum. Bull. 327 was in effect when the debentures were authorized and continued in effect until after the issue of the debentures by petitioner—1936 C. C. H. Federal Tax Service, Vol. 1, par. 822.522; 1939 C. C. H. Fed. Tax Service Vol. 1, par. 822.263. Indeed there was no contrary ruling until Regs. 103 § 19.504-2 (a), promulgated January 29, 1940 which was argued in the Court of Appeals to apply to I. R. C. § 23(a) although in terms it purports to apply only to personal holding companies.

Third Scottish-American Trust Company, Ltd. v. U. S., 37 F. Supp. 279, 283 (Ct. Cl. 1931) involved both debentures and debenture stock certificates. The latter specified no maturity prior to dissolution; the Court held payments of interest on them deductible. It said—

> "It is true that the holders of these certificates could not demand a return of the principal so long as the company was not in default in the payment of interest and so long as it complied with the other conditions of the indenture securing them; but this alone is not sufficient to characterize the transaction as a purchase of shares in the company, rather than a loan of money to it."

Com. v. Lafayette L. I. Co., 67 F. 2d 209, 213 (7 C. C. A. 1933). Interest actually paid held deductible whether based on a legal liability or on an equitable or moral obligation only and even though the time of payment was conditional.

Commissioner v. National Grange Mutual Liability Company, 80 F. 2d 316 (1 C. C. A. 1935). Amendment of the company's Articles of Incorporation for the purpose of avoiding taxation provided for the issue of guarantee fund units in exchange for outstanding preferred stock. These units bore interest at seven per cent per annum payable whenever the company should have a surplus of 10 per cent or more of gross annual premium income, cumulative until paid, and were redeemable by the company only upon order of the Board of Directors and permission of the Commissioner of Insurance. They carried no direct obligation for payment of principal or interest, except upon liquidation and were not shown as a liability upon the books of the company. Rights on liquidation were substantially the same as those of the pre-existing preferred stock.

In *Helvering v. Richmond F & P R Co.*, 90 F. 2d 971, 973 (4 C. C. A. 1937) affirming 33 B. T. A. 895, 899 (Jan. 9, 1936) involving so-called seven per cent and six per cent guaranteed stock which had voting rights and no maturity in absence of default, the Court said (p. 974)—

> "The fact that the principal of the guaranteed stock is not demandable by the stockholder in the absence of default in the payment of the guaranteed dividends is not conclusive of a stock investment. In the light of the other attributes of the stock, this indicates rather a debt as to which there is a right of renewal so long as the interest is paid when due. There is nothing in the fact that the debt evidenced by the preferred stock is not payable at a fixed time which throws upon the holders thereof any of the risks with respect to the corporate enterprise which are characteristic of the position of the stockholder."

Staked Plains Trust, Ltd., 12 P-H T. C. Memo, par. 43,381 (1943) affirmed 143 F. 2d 421 (5 C. C. A. 1944). Class A liquidation certificates issued upon reorganization held to create a debt even though not payable at a fixed time since the holders were entitled to receive specified amounts with interest at a given rate per year as and when such payment should be authorized by the Trustees of the trust and the total amount, including both principal and interest, must be paid before any payments are made either from income or distribution of capital in respect of the liquidation rights or of the shares of said trust. The Tax Court held (page 43-1193)—

> "* * * the parties must be presumed to know the difference between bonds and shares and when they adopt a form of certificate incorporating elements of one or the other, their acts must be given the intended effect, unless there is evidence that the certificates did not recite what they were intended to mean. North-

ern Fire Apparatus Co., 11 BTA 355. Here the intent and form are in accord."

It is not correct to say that the preferred debentures have no maturity date. If no date for payment were set forth, then under the Uniform Negotiable Instruments Law, § 7(2), (G. C. § 8112) (App. A, *infra*, p. 22), they would be payable on demand. Admittedly, the preferred debentures have no fixed maturity date in the sense that one can point to a date certain on which they will be payable but they do mature on a determinable future date, to wit, the date of taxpayer's liquidation, an event which is certain to happen though the time of happening is uncertain. Such a specification does not prevent the creation of a legal indebtedness any more so than a specification that an obligation is payable upon or within a certain period after the death of the maker or upon demand. Under Section 4 (3) of the Negotiable Instruments Law (G. C. § 8109) (App. A, *infra*, pp. 21-22) an instrument is payable at a determinable future time within the meaning of the law, which is expressed to be payable on or before a fixed or determinable future time specified therein; or on or at a fixed period after the occurrence of a specified event, which is certain to happen, though the time of happening be uncertain; an instrument payable upon a contingency is not negotiable.

An instrument payable on or within a specified time after death is negotiable within the provisions of this section. *In re Holtorf's Estate*, 28 N. W. 2d 155; *In re Conger's Estate*, 184 N. Y. S. 74; *Keeler v. Hiles' Estate*, 172 N. W. 363.

But if there were no fixed or determinable date of maturity or one which might be fixed by demand, that would only affect the negotiability of the instrument (G. C. § 8109) and would not make it any the less an evidence

of indebtedness. A written promise to pay a certain sum upon the happening of contingency is none the less legal as a binding obligation to pay money by reason of the fact that the day of maturity might not arrive—*Harris v. Firth*, 68 A. 1064 (N. J.); *Com v. Lafayette L. I. Co.*, 67 F. 2d 209, 213 (7 C. C. A. 1933).

In times past, the British government has issued its "Consols" or "Consolidated Fund Certificates" and the French government its "Rentes," neither of which stipulated any certain maturity; the principal thereunder is returned only at the option of the government in each case; but as pointed out in *A. R. R.* 237 (3 Cum. Bull. 327, 329), *supra*, p. 7, such instruments are a species of indebtedness.

Priority of General Creditors Is Not the Test.

The holding of the District Court affirmed by the Court of Appeals that an arrangement whereby the preferred debenture holders are upon liquidation to be junior to general creditors is not compatible with the creation of debt conflicts in principal with other decision of the courts, *Commissioner v. National Grange Mutual Liability Company*, 80 F. 2d 316 (1 C. C. A. 1935); *John Kelley Co. v. Com.*, 326 U. S. 521, 523, 66 S. Ct. 299, 301 (1946); *Com. v. Proctor Shop*, 82 F. 2d 792, 793 (10 C. C. A. 1936); *Idaho Lumber & Hardware Co.*, 14 P-H memo. T. C. par. 45,085 (1945); *Elliott-Lewis Company, Inc.*, 14 P-H Memo. T. C. par. 45,047 (1945); *U. S. v. Title Guarantee & Trust Co.*, 133 F. 2d 990 (6 C/A 1943) (Syl. 9):

> "Where 6 per cent preferred stock certificates were payable on maturity notwithstanding current defaults, and certificate holders had no voice in corporate management and intention of agreement between corporation and holders was that stock should be a debt

> of corporation subordinated to general creditors, the stock constituted 'indebtedness' and dividends paid thereon were 'interest' payments which were deductible in determining corporation's income tax. 26 U. S. C. A. Int. Rev. Code, § 23."

In that case, as distinguished from the cases at bar, the obligation was not carried as indebtedness on the books of the taxpayer.

Investment of New Capital Is Not Essential to Indebtedness.

The additional reason of the Court below that the preferred debentures were not issued for new capital conflicts with other holdings prior to and after 1937 that new capital is not essential to the creation of indebtedness.

It is not essential to indebtedness that it shall have been created in exchange for new money or capital lent to the taxpayer. *John Kelley Co. v. Commissioner*, 326 U. S. 521, 66 S. Ct. 299 (1946) involved eight per cent debentures issued in 1936 in large part in exchange for preferred stock and the balance in exchange for dividends paid by the taxpayer to the common shareholders for that purpose.

Commissioner v. National Grange Mutual Liability Company, 80 F. 2d 316, 319 (1 C. C. A. 1935) affirming 31 B. T. A. 666 (Guarantee fund units issued in exchange for outstanding preferred stock).

Com. v. J. N. Bray Co., 126 F. 2d 612 (5 C. C. A. 1942) involved eight per cent debenture preferred stock issued in exchange for common stock in 1937.

Elliott-Lewis Co., Inc., 14 P-H Memo T. C. par. 45,047 (1945) (Class A debentures issued in exchange for common stock).

Idaho Lumber & Hardware Co., 14 P-H Memo T. C. par. 45,085 (1945) (Eight per cent debentures issued in exchange for 90 per cent of the common stock).

250 Hudson St. Corp., 15 P-H Memo T. C. par. 46,205 (1946) (Debentures issued in exchange for preferred stock).

Bowersock Mills & Power Co. v. Com., 172 F. 2d 904 (10 C. A. 1949). Dividends (payable only if earnings are sufficient) on so-called preferred stock issued in exchange for first mortgage bonds in default in order to improve credit standing held deductible as interest.

New England Lime Co. v. Com., 13 T. C. 799 (1949) involved three to nine per cent debentures issued in 1942 in exchange for preferred stock.

Lansing Hotel Corporation, 14 T. C. 183, 189 (1950). Debentures issued against earned surplus to the extent of $14,373.73 and paid-in surplus resulting from reduction of par value of common stock to the extent of $448,726.27.

Sabine Royalty Corp., 17 T. C. 1071, 1076 (1951) involved eight per cent cumulative debentures issued in exchange for common stock.

Kraft Foods Co. v. Com., 232 F. 2d 118, 126 (2 C. A. 1956).

> "* * * the very pattern of the tax statute recognizes that indebtedness may be created by a distribution or by a recapitalization exchange through the issuance of securities out of capital or earnings or both, though the tax treatment may vary with the method chosen."

Doctrine of Thin Capitalization Does Not Apply.

The Court of Appeals observed that the preferred debentures had a face value nearly ten times the stockholders' equity. Actually the face value of the preferred

debentures and preferred shares not yet exchanged on December 31, 1936 ($192,000) was less than six (6) times the equity ($32,567.76) of the common shares (per books) as shown in Ex. 3 (not printed but attached to Stipulation designated "Plaintiff's Exhibit A-2"); but the latter takes no account of appreciation in value or the many other factors affecting actual value of the corporate assets. The doctrine of thin capitalization is one which had not developed at the time of the issue of these debentures and we submit that it is not applicable here. It was not raised as late as 1945 in *1432 Broadway Corp. v. Com.*, 4 T. C. 1158. A proportion of $538,100 debentures to $57,220.80 equity for preferred and common shares per books was approved in *New England Lime Co. v. Com.*, 13 T. C. 799, 802, 804 (1949). The contrary case of *Mullin Building Corp. v. Commissioner*, 9 T. C. 350, 358 (1947) involved a ratio of 29 to 1. Furthermore, the Debenture Preferred Stock involved in that case was provided for in the Articles of Incorporation and was shown on the taxpayer's books and represented to the business world as capital.

Business Purpose Not Essential But Present.

In the courts below, Respondent's counsel raised a question as to the business purpose of the issuance of the debentures. The business purpose doctrine is founded on the need to prevent perversion of the tax-free exchange provisions of the law—*Bazley v. Com.*, 331 U. S. 737, 67 S. Ct. 1489. But here the exchange of preferred stock for preferred debentures was recognized as taxable and the law does not require a further business purpose for the deduction of interest on the debentures thereafter. There is no inconsistency between holding that a shareholder is taxable on the receipt of debentures in a recapitalization

not motivated by a business purpose and holding that interest paid on the debentures is deductible. *Cleveland Adolph Mayer Realty Corp.*, 6 T. C. 730, 741; *Toledo Blade Co.*, 11 T. C. 1079; *Andersen Corp.*, 15 P. H. T. C. Memo. par. 46,116—

> "We find no evidence that the transaction was a sham. Nor is it important whether a business purpose was served by the 1937 reorganization. The question is whether the debentures issued in that reorganization constituted indebtedness of the petitioner and the amounts paid as 'interest' thereon, thus deductible from gross income. In the case of Cleveland Adolph Mayer Realty Corp., 6 T. C. (No. 95), (promulgated April 16, 1946), where a similar question was presented and the same argument by respondent was urged, we said:
>
> "Whether or not the reorganization of the corporation effected in years prior to the taxable year was a reorganization within the meaning of the taxing act in effect in that year has no bearing upon this question."

250 *Hudson St. Corp.*, 15 P. H. T. C. Memo. Par. 46,205.

Kraft Foods Co. v. Com., 232 F. 2d 118, 127 (2 C. A. 1956) (p. 127):

> "4. *Business Purpose.*
>
> "The Commissioner contends that the debenture issue should be disregarded for tax purposes because it served no business purpose other than the minimization of taxes. Although the taxpayer attempts to find a business purpose in the replacement of an artificial financial structure with a more realistic one, it concedes that tax considerations were the primary motivation of the debenture issue. Assuming, then,

that the purpose of the transaction was to minimize taxes, should the transaction be disregarded because of its tax motivation?

> "[20] The Commissioner argues that transactions, though formally perfect and in compliance with a provision of the tax statute, must be disregarded if they have no purpose germane to the conduct of the business other than tax minimization. He relies on Gregory v. Helvering, 1935, 293 U. S. 465, 55 S. Ct. 266, 79 L. Ed. 596; Minnesota Tea Co. v. Helvering, 1938, 302 U. S. 609, 58 S. Ct. 393, 82 L. Ed. 474; Griffiths v. Helvering, 1939, 308 U. S. 355, 60 S. Ct. 277, 84 L. Ed. 319; Higgins v. Smith, 1941, 308 U. S. 473, 60 S. Ct. 355, 84 L. Ed. 406; Commissioner of Internal Revenue v. Court Holding Co., 1945, 324 U. S. 331, 65 S. Ct. 707, 89 L. Ed. 981; Bazley v. Commissioner, 1947, 331 U. S. 737, 67 S. Ct. 1489, 91 L. Ed. 1782; Commissioner of Internal Revenue v. Culbertson, 1949, 337 U. S. 733, 69 S. Ct. 1210, 93 L. Ed. 1659. We do not think that these cases hold that tax minimization is an improper objective of corporate management; they hold that transactions, even though real, may be disregarded if they are a sham or masquerade or if they take place between taxable entities which have no real existence. The inquiry is not what the purpose of the taxpayer is, but whether what is claimed to be, is in fact."

Here there was an excellent business purpose for the refinancing by Petitioner in 1936-1937 involving the issue of Common Debentures as a dividend upon common shares and the offer and issue of Preferred Debentures in exchange for preferred shares then issued and outstanding. Section 14 of the Revenue Act of 1936 imposed a surtax of seven to twenty-seven percent (7-27%) on undistributed profits of corporations with certain credits. In order to conserve its cash position as much as possible, Petitioner,

after paying cash dividends to obtain credit under this act, paid a dividend in Common Debentures of the corporation which was fully taxable; but it was realized that by so doing, the common shareholders would obtain an evidence of indebtedness which would be prior to the preferred shares. In order to avoid such a preference the corporation authorized the creation and issue in exchange for preferred shares of the Preferred Debentures which were prior to the Common Debentures by the express terms of both.

An additional tax result of this refinancing was the deductibility of interest on both the Preferred and Common Debentures under Section 23 of the Revenue Act (*infra*, p. 19).

The Trial Court Erred in the Exclusion of Evidence.

By its affirmance, the Court of Appeals approved the action of the District Court in excluding evidence showing that former preferred shareholders reported taxable gain upon the exchange of the preferred shares for preferred debentures; that the Petitioner on its books, in Federal capital stock tax and income tax information returns, state franchise tax returns and other action consistently treated the preferred debentures as indebtedness and the quarterly payments made thereon as interest. The trial court held these were not material. In this respect its judgment and that of the Court of Appeals are in conflict in principal with the decisions in the following cases:

Helvering v. Richmond F & P R Co., 90 F. 2d 971, 975 (1937) affirming 33 B. T. A. 895 (1936); *Com. v. O. P. P. Holding Corp.*, 76 F. 2d 11, 12 (2 C. C. A. 1935); *U. S. Title v. Guarantee & Trust Co.*, 133 F. 2d 990, 995.

CONCLUSION.

It is respectfully submitted that this petition for a writ of certiorari should be granted.

ROBERT G. DAY,
Attorney for Petitioner.

H. H. HOPPE,
HOPPE, DAY & FORD,
Second National Building,
Warren, Ohio,
Of Counsel.

APPENDIX A.

STATUTES INVOLVED.

Revenue Act of 1939.

Sec. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

Revenue Act of 1936.

Sec. 14. SURTAX ON UNDISTRIBUTED PROFITS,

(a) *Definitions.*—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—

* * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

17 per centum of the portion of the undistributed net income which is in excess of 20 per centum and not in excess of 40 per centum of the adjusted net income.

22 per centum of the portion of the undistributed net income which is in excess of 40 per centum and not in excess of 60 per centum of the adjusted net income.

27 per centum of the portion of the undistributed net income which is in excess of 60 per centum of the adjusted net income.

(c) *Adjusted Net Income Less than $50,000.*—

(1) *Specific Credit.*—If the adjusted net income is less than $50,000 there shall be allowed a specific credit equal to the portion of the undistributed net income which is in excess of 10 per centum of the adjusted net income and not in excess of $5,000, such credit to be applied as provided in paragraph (2).

(2) *Application of Specific Credit.*—If the corporation is entitled to a specific credit, the tax shall be equal to the sum of the following:

(A) A tax computed under subsection (b) upon the amount of the undistributed net income reduced by the amount of the specific credit, plus

(B) 7 per centum of the amount of the specific credit.

* * * * *

Sec. 27. CORPORATION CREDIT FOR DIVIDENDS PAID.

(a) *Dividends Paid Credit in General.*—For the purpose of this title, the dividends paid credit shall be the amount of dividends paid during the taxable year.

* * * * *

(d) *Dividends in Obligations of the Corporation.*—If a dividend is paid in obligations of the corporation, the amount of the dividends paid credit with respect thereto shall be the face value of the obligations, or their fair market value at the time of the payment, whichever is the lower. If the fair market value is lower than the face value, then when the obligation is redeemed by the corporation, the excess of the amount for which redeemed over the fair market value at the time of the dividend payment (to the extent not allowable as a deduction in computing net income for any taxable year) shall be treated as a dividend paid in the taxable year in which the redemption occurs.

* * * * *

(h) *Nontaxable Distributions.*—If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, no dividends paid credit shall be allowed with respect to such part.

General Code of Ohio.

Sec. 8109. (Now R. C. § 1301.06). *What constitutes determinable future time.* An instrument is payable at a determinable future time within the meaning of this chapter, which is expressed to be payable:

1. At a fixed period after date or sight; or
2. On or before a fixed or determinable future time specified therein; or
3. On or at a fixed period after the occurrence of a specified event, which is certain to happen, though the time of happening be uncertain.

An instrument payable upon a contingency is not negotiable, and the happening of the event does not cure the defect. (R. S. Sec. 3171c).

Sec. 8112. (Now R. C. § 1301.09). *When payable on demand.* An instrument is payable on demand:

* * * * *

2. In which no time for payment is expressed.

When an instrument is issued, accepted, or indorsed when overdue, it is, as regards the person so issuing, accepting, or indorsing it, payable on demand.

APPENDIX B.

ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT—FILED JANUARY 4, 1957.

On this appeal by the taxpayer, Beaver Pipe Tools, Inc., from the decision of the district court dismissing its complaint, the issue is whether interest paid by the taxpayer on preferred debentures having no fixed maturity date, issued by the taxpayer in exchange for its outstanding cumulative preferred stock, is deductible as interest on indebtedness within the meaning of 26 U. S. C., section 23 (b).

United States District Judge Paul Jones, in a succinct and logical opinion, held that interest so paid is not deductible. He considered that the maturity date of the preferred debentures, being "upon liquidation of the company," did not constitute "a fixed date" or a certain time, as required by the aforementioned statute and the regulation promulgated thereunder.

We are in accord with his reasoning. In addition to having no fixed maturity date, the debentures in question were not issued for new capital, had a face value nearly ten times the stockholders' equity, and were junior to the claims of general creditors. We find on the whole record that no other point presented by appellant has been established to gainsay the correctness of the decision of the district court.

Accordingly, the order dismissing the taxpayer's complaint is ordered to be affirmed.

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statute involved	2
Statement	2
Argument	6
Conclusion	10

CITATIONS

Cases:	
Bazley v. *Commissioner*, 331 U. S. 737	9
Bowersock Mills & Power Co. v. *Commissioner*, 172 F. 2d 904	7
Commissioner v. *Meridian & Thirteenth R. Co.*, 132 F. 2d 182	7
Comstock v. *Group of Investors*, 235 U. S. 211	8
Corn Products Co. v. *Commissioner*, 350 U. S. 46	8
Earle v. *W. J. Jones & Son*, 200 F. 2d 846	7
Gooding Amusement Co. v. *Commissioner*, 236 F. 2d 159, certiorari denied, 352 U. S. 1031	6
Helvering v. *Winmill*, 305 U. S. 78	6
John Kelley Co. v. *Commissioner*, 326 U. S. 521	7, 8
John Wanamaker Philadelphia v. *Commissioner*, 139 F. 2d 644	7
Matthiessen v. *Commissioner*, 194 F. 2d 659	7
Rowan v. *United States*, 219 F. 2d 51	7
Washmont Corp. v. *Hendricksen*, 137 F. 2d 306	7
Wetterau Grocer Co. v. *Commissioner*, 179 F. 2d 158	7
Statute:	
Internal Revenue Code of 1939, Sec. 23 (b) (26 U. S. C. 1952 ed., Sec. 23 (b))	2, 6
Miscellaneous:	
Treasury Regulations 86, Art. 23 (b)–1	6
Treasury Regulations 94, Art. 23 (b)–1	6
Treasury Regulations 101, Art. 23 (b)–1	6
Treasury Regulations 103, Sec. 19.23 (b)–1	6
Treasury Regulations 111, Sec. 29.23 (b)–1	6

424230—57

In the Supreme Court of the United States

OCTOBER TERM, 1956

No. 868

BEAVER PIPE TOOLS, INC., PETITIONER

v.

THOMAS M. CAREY

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (R. 69a–71a)[1] is reported at 139 F. Supp. 470. The opinion of the Court of Appeals (Pet. 23) is reported at 240 F. 2d 843.

JURISDICTION

The judgment of the Court of Appeals was entered on January 4, 1957. The petition for a writ of certiorari was filed on March 29, 1957. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

[1] References designated "R." are to the record printed as the appendix to taxpayer's brief in the Court of Appeals.

QUESTION PRESENTED

Whether the record warrants the District Court's conclusion, affirmed by the Court of Appeals, that "8% Preferred Debentures" issued by taxpayer corporation to its controlling stockholders evidenced capital contributions rather than bona fide indebtedness, and that consequently earnings of the corporation distributed to the stockholders as "interest" on the debentures were not deductible under Section 23 (b) of the Internal Revenue Code of 1939.

STATUTE INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

* * * * *

(26 U. S. C. 1952 ed., Sec. 23.)

STATEMENT

The taxpayer, Beaver Pipe Tools, Inc., an Ohio corporation, brought this action in the United States District Court for the Northern District of Ohio to recover $104,382.71, plus interest, in income and ex-

cess profits taxes for the years 1940 through 1949. (R. 7a–8a, 13a.)

For each of those years, taxpayer paid $15,360 to the holders of its "8% Preferred Debentures" from its current or accumulated earnings and profits. It deducted such amounts as interest in computing its taxable income. The Commissioner of Internal Revenue disallowed such deductions and assessed the resulting deficiencies, which were paid prior to commencement of the action. (R. 16a–19a, 63a.)

During the time here material, taxpayer was controlled by two related families which owned over two-thirds of its stock. (R. 20a, 23a, 26a.) In October 1936, taxpayer had outstanding 1,920 shares of 8% cumulative preferred stock having an aggregate par or stated value of $192,000 and 8,000 shares of common stock having a stated value of $8,000. (R. 14a–16a.) In December 1936, taxpayer's directors authorized the issuance of $192,000 in principal amount of "8% Preferred Debentures to be used solely for the purpose of exchanging the same for preferred shares in the company * * *." (R. 37a.) The exchange was made at the end of 1936 and the beginning of 1937. (R. 22a.) The two families holding the controlling common stock also owned in excess of 75% of the principal amount of the 8% preferred debentures immediately after they were issued, and still held them in August 1955. (R. 20a, 23a, 24a.)

Taxpayer's purpose in issuing the 8% preferred debentures in exchange for its outstanding 8% cumulative preferred stock was stated by the board of directors as follows (R. 40a):

> One of the main reasons for the issuance of the debentures, both common and preferred, is that, in determining the net income of the Company for income tax purposes, dividends are not a deductible item, whereas interest paid upon the debentures will be a deductible item, just as any other interest.

With reference to the exchange of preferred debentures for preferred stock, the holders of the preferred stock were advised by the directors that "The Preferred Debentures contain substantially the same terms and provisions as are found in the preferred shares." (R. 37a.)

At the same time as this exchange, taxpayer declared a dividend of $15 per share on its 8,000 shares of common stock, payable out of paid-in surplus. This dividend of $120,000 was paid in taxpayer's ten-year 6% common debentures, the principal sum of which was payable on December 31, 1946. (R. 27a, 32a.) These common debentures were fully redeemed prior to their maturity date. (R. 45a.)

The 8% preferred debentures contained no fixed maturity date on which the principal amount would be payable; they were payable only upon liquidation of the company. (R. 31a.) In addition, they provided in substance (R. 28a–32a):

> 1. The rights of the holders are superior to those of the holders of the common debentures and the shareholders "but shall be junior and subordinate to the rights of all other creditors."
>
> 2. If the interest or principal becomes due and remains unpaid and if funds therefor have

not been set aside, no interest on the common debentures and no dividends are to be paid.

3. They are subject to redemption at 110% of their principal amount at "the option of the board of directors."

4. In the event of liquidation, they "immediately become due and payable" and the holders are entitled to receive the unpaid principal and interest from the assets "remaining after paying the debts and liabilities." No sale of the taxpayer's assets, reorganization, consolidation or merger is deemed to be a liquidation "unless the board of directors of the Corporation shall otherwise determine."

5. If "interest" thereon is in arrears "for a period of three years" or in the event of any other default, the principal amount becomes immediately due and payable, provided the holders of 75% of the principal amount so elect. They "may however waive any such default."

6. No holder "of less than 75% in principal amount of the Preferred Debentures shall have any right to commence suit or obtain judgment thereon."

If the preferred debentures represent borrowed capital (as taxpayer asserts) rather than equity capital, then after their issuance the debt-equity ratio of taxpayer's capital structure was approximately ten to one. (R. 59a–60a.)

When taxpayer issued the preferred debentures, the interest rate on commercial loans was approximately 3% and corporate bond yield ranged from 3% to slightly more than 4½%. The 8% yield on the preferred debentures was nearly twice the prevailing rate for loans to corporate borrowers. (R. 64a–65a.)

The preferred debentures have not been reacquired by the taxpayer.

The District Court found and held that the preferred debentures did not represent indebtedness within the meaning of Section 23 (b) of the Internal Revenue Code of 1939, and hence that the so-called "interest" paid thereon was not deductible. (R. 70a–71a.) The Court of Appeals affirmed *per curiam*. (Pet. 23.)

ARGUMENT

The question here is essentially the same as was presented in *Gooding Amusement Co.* v. *Commissioner*, 236 F. 2d 159 (C. A. 6th), in which the taxpayer's petition for certiorari was recently denied. 352 U. S. 1031. There is no more occasion for further review of this case than of that one. The issue is essentially one of fact; the decision below is correct; and no conflict exists.

1. The payments in question constituted deductible "interest" only if the "Preferred Debentures" represented genuine indebtedness as distinguished from risk capital.[2] Whether a so-called debt instrument issued by a corporation to its controlling stockholders

[2] Section 23 (b) of the Internal Revenue Code of 1939 (*supra*, p. 2) does not permit a corporation to deduct in the guise of interest on indebtedness what in reality constitutes a dividend on stock. Long-standing Treasury Regulations under Section 23 (b) provided that "[s]o-called interest on preferred stock, which is in reality a dividend thereon, can not be deducted in computing net income." Art. 23(b)–1 of Regulations 86, 94, 101, and Secs. 19.23(b)–1 and 29.23(b)–1 of Regulations 103 and 111, respectively. Under familiar principles, the Regulations are deemed to have received implied legislative approval. *Helvering* v. *Winmill*, 305 U. S. 79, 83.

does reflect a true debt—or instead merely a vehicle for the distribution of dividends—presents a question of ultimate fact in each case, depending on all the relevant circumstances and terms of the instrument. *John Kelley Co.* v. *Commissioner*, 326 U. S. 521. The courts of appeals, including those with whose decisions taxpayer alleges conflict, have uniformly so held.[3]

After carefully weighing all of the evidence, the District Court concluded (R. 69a–71a) that the so-called preferred debentures in substance reflected a proprietary rather than a creditor interest in the corporation, and, as the court below pointed out (Pet. 23), that conclusion is amply supported by the record. The debentures lacked several important features characteristic of indebtedness, and the circumstances surrounding their issuance confirm the conclusion that they were not intended to represent bona fide indebtedness. As the Court of Appeals stated in affirming (Pet. 23): "In addition to having no fixed maturity date, the debentures in question were not issued for new capital, had a face value nearly ten times the stockholders' equity, and were junior to the claims of general creditors". Since the issue is one of fact, the concurrent findings of both courts below

[3] See, *e. g.*, *Washmont Corp.* v. *Hendricksen*, 137 F. 2d 306 (C. A. 9th); *Matthiessen* v. *Commisioner*, 194 F. 2d 659 (C. A. 2d); *John Wanamaker Philadelphia* v. *Commissioner*, 139 F. 2d 644 (C. A. 3d); *Rowan* v. *United States*, 219 F. 2d 51 (C. A. 5th); *Commissioner* v. *Meridian & Thirteenth R. Co.*, 132 F. 2d 182 (C. A. 7th); *Wetterau Grocer Co.* v. *Commissioner*, 179 F. 2d 158 (C. A. 8th); *Earle* v. *W. J. Jones & Son*, 200 F. 2d 846 (C. A. 9th); *Bowersock Mills & Power Co.* v. *Commissioner*, 172 F. 2d 904 (C. A. 10th).

are entitled to finality here. *Corn Products Co.* v. *Commissioner,* 350 U. S. 46, 51; *Comstock* v. *Group of Investors,* 335 U. S. 211, 214.

2. Taxpayer's repeated assertions (Pet. 6, 11, 17) of conflict between the decision below and decisions of other courts of appeals are without substance. The cases dealing with the general issue here presented are legion, and each turns as it must on its own particular facts. The ones cited by taxpayer, like the many others in this area, stand merely for the proposition that all the relevant circumstances are to be considered, no single factor being conclusive. That this was the approach taken by the courts below is apparent from their opinions.

The most that may be said in taxpayer's favor is that the debentures in question constituted hybrid securities bearing indicia of both debt and stock, and that conflicting inferences might reasonably have been drawn as to whether they were intended to create a debtor-creditor relationship as distinguished from a corporation-stockholder relationship. But in such a situation, as this Court made clear in the *Kelley* case (*supra*), the determination of whether the arrangement falls in one category or the other is peculiarly within the province of the fact-finding tribunal. Where as here the alleged indebtedness purportedly replaces a stock interest, has no fixed maturity date, and is subordinated to outside claims, the trial court's conclusion that the debt instrument does not evidence

genuine indebtedness cannot be said to be clearly erroneous, and the affirmance of that conclusion by the Court of Appeals was fully justified.[4]

3. There is no merit in taxpayer's contention (Pet. 17) that the District Court committed prejudicial error in excluding evidence as to the manner in which the stockholders treated the exchange in their tax returns. The proffered evidence does not bear out taxpayer's assumption that the exchange was reported as a taxable event (R. 43a–44a, 49a), but, even assuming that it does, the treatment accorded the exchange by the stockholders manifestly would not be determinative of whether the debentures are to be treated as the corporation's indebtedness. In any event, the District Court considered the proffered evidence (R. 71a), and properly declined to view it as conclusive of the issue.

Equally without merit is taxpayer's contention (Pet. 17) that the manner in which it recorded the payments in question on its books and reported them on its returns is determinative of their deductibility under the taxing statute. See *Bazley* v. *Commissioner*, 331 U. S. 737, 741.

[4] The fact that the "preferred debentures" contained substantially the same provisions, as well as the same 8% rate, as the preferred stock for which they were exchanged (R. 37a), and the fact that this rate was nearly twice the prevailing market rate on corporate loans (R. 64a–65a), lend further support to the District Court's conclusion.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari should be denied.

J. LEE RANKIN,
Solicitor General.
CHARLES K. RICE,
Assistant Attorney General.
HARRY BAUM,
WALTER R. GELLES,
Attorneys.

APRIL 1957.

U. S. GOVERNMENT PRINTING OFFICE: 1957

FILED
MAY 2 19
JOHN T. FEY, C

In the Supreme Court of the United States

OCTOBER TERM, 1956.

No. 868.

BEAVER PIPE TOOLS, INC.,
Petitioner,

vs.

THOMAS M. CAREY,
Respondent.

REPLY BRIEF ON PETITION FOR CERTIORARI.

ROBERT G. DAY,
Second National Building,
Warren, Ohio,
Attorney for Petitioner.

H. H. HOPPE,
HOPPE, DAY & FORD,
Of Counsel.

THE GATES LEGAL PUBLISHING CO., CLEVELAND, OHIO—MAIN 1-8847

In the Supreme Court of the United States

OCTOBER TERM, 1956.

No. 868.

BEAVER PIPE TOOLS, INC.,

Petitioner,

vs.

THOMAS M. CAREY,

Respondent.

REPLY BRIEF ON PETITION FOR CERTIORARI.

The Respondent in footnote 2 on page 6 of his brief refers to the doctrine of *Helvering v. Winmill,* 305 U. S. 79 (1938). Under that decision, Treasury regulations and interpretations long continued without substantial change applying to unamended or substantially reenacted statutes are deemed to have received Congressional approval and have the effect of law. Accordingly, Appeal and Review Recommendation No. 237 published by the Bureau of Internal Revenue in 1920 (3 Cum. Bull. 327) that debenture stock, the face amount of which was payable on dissolution or at the expiration of corporate existence of the issuer, is indebtedness and the interest thereon deductible, should be considered as having the effect of law on down through January 29, 1940 when for the first time a collateral contrary ruling was promulgated. This is discussed in our petition for certiorari (pages 7, 11).

The cases cited in footnote 3 on page 7 of Respondent's brief do not militate against Petitioner's position.

In *Washmont Corp. v. Hendricksen,* 137 F. 2d 306 (C. A. 9th) the holders of the certificates involved were

to share equally in earnings with the common stockholders after each had received specified dividends and upon liquidation were to participate in assets along with the common stockholders. In addition, the Taxpayer had represented to its bank that the certificates were capital stock and the bank had relied upon that representation.

In *Matthiessen v. Commissioner*, 194 F. 2d 659 (C. A. 2d) a holding that advances from time to time by petitioners to their wholly owned corporation were capital contributions was held not clearly erroneous.

In *John Wanamaker Philadelphia v. Commissioner*, 139 F. 2d 644 (C. A. 3d) preferred stock issued to a principal shareholder in payment of a debt due him, authorized by resolution of the directors and approved by the shareholders was held to be stock. Under its terms this stock was deferred to payment of the common capital stock upon dissolution, voluntary liquidation or sale of the property and assets of the corporation.

Commissioner v. Meridian & Thirteenth R. Co., 132 F. 2d 182 (C. A. 7th) involved preferred stock entitled to cumulative dividends payable out of earnings only and providing for redemption at definite maturity dates, all as authorized by the taxpayer's Articles and the statutes of Indiana.

In *Rowan v. United States*, 219 F. 2d 51 (C. A. 5th) advances by a husband and wife to their wholly owned corporation and in *Earle v. W. J. Jones & Son*, 200 F. 2d 846 (C. A. 9th) advances by the principal shareholder to a corporation owned by himself, his wife and two sons were held to constitute indebtedness; as was also the issue of so-called preferred stock in *Bowersock Mills & Power Co. v. Commissioner*, 172 F. 2d 904 (10 C. A. 1949).

In *Wetterau Grocer Co. v. Commissioner*, 179 F. 2d 158 (C. A. 8th) the instruments involved were not negotiable, the amount of "interest" was not fixed by them and its payment was not definite but dependent on earnings and at the discretion of the board.

Respectfully submitted,

ROBERT G. DAY,
Attorney for Petitioner.

H. H. HOPPE,
HOPPE, DAY & FORD,
Second National Building,
Warren, Ohio,
Of Counsel.